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The PERAC Financial Bulletin

In a year that saw the welcome re-emergence of the bull as well as the unwelcome discovery of a mad cow, 2003 chased away the bear in dramatic fashion.

FINANCIAL
MARKET
REVIEW
4th Quarter, 2003



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NO. 20 | JANUARY, 2004

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5 Middlesex Avenue

Third Floor

Somerville, MA

02145

ph 617 666 4446

fax 617 628 4002

tty 617 591 8917

web www.mass.gov/perac



Spurred by sizeable tax cuts (affecting income, capital gains, and dividends), the lowest interest rates in a generation, lean inventories, and a lower dollar, the US economic machine began to regain momentum. The economic growth rate of 8.2% for the third quarter was the fastest in twenty years, and profits were heading for their best year of growth since 1999. After reaching a low for the year when the war in Iraq began in March, the stock market recovered and never looked back. (See Chart One)

After rising 12.7% for the quarter and 25.3% for the year, the Dow Jones Industrials closed at its

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highest level in over 20 months. It has rebounded 43% from its low of October 9, 2002, but having only recently regained the 10,000 level it first achieved in early 1999, the ravages of the three-year bear market are still apparent. At year-end, the Index needed a 12.1% rally to match its record high of January 14, 2000.

The S&P 500 large cap index was up 11.6% for the quarter and 26.4% for the year. The Index regained the 1100 mark for the first time since May 2002 but still needed to rise 37.4% to match its record high of March 24, 2000.

Up 14.2% for the quarter and 45.4% for the year, the Russell 2000 small cap index enjoyed its best year ever. The Index reached its highest level in almost four years, and is only 9% from regaining its record high of March 9, 2000. It was the fourth consecutive year that small caps outperformed large caps. (See Chart Four)

The NASDAQ Composite registered a remarkable performance, up 12.1% for the quarter and 50.0% for the year. It was the

Index's third biggest annual gain since 1971. The Index has risen 80% from its October 2002 low, but since it fell 78% from its March 2000 peak, it still needed to rise 152% to regain that level.

The frothy performance of the NASDAQ raised fears that the worrisome trends of the late 1990s bubble had returned. Indeed, the best performing stocks for the year were generally the lowest quality, most heavily indebted, and least viable companies. The best performing S&P market sectors were information technology, up 46.6%, and consumer discretionary stocks, up 36.1%, while the worst was telecommunications services, up only 3.3%. Indicating the range of performance, Nextel was up 143% while AT&T fell 22.3%. Among the 30 Dow Industrials, Intel surged 106%, but the picture was not pretty at Eastman Kodak, down 26.7% as the company was seen as slow to respond to the growth in digital photography.

Value outperformed growth during the fourth quarter, but there was little to choose between

Chart 1 | S&P 500 in 2003: After Iraq, a Steady Rise

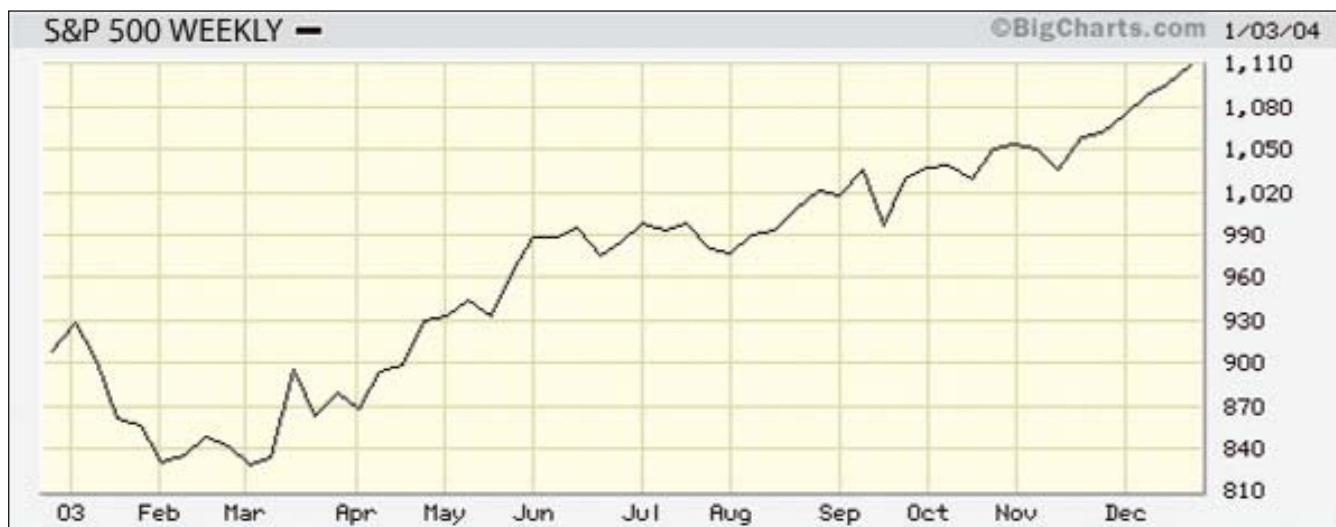


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the two styles over the course of 2003. Over trailing 3, 5, and 10-year periods, value has the edge.

Just as all major regions of the world economy suffered through the past recession, this year's recovery has also been synchronous worldwide. Aided by the weakness of the US dollar, which was down 20% vs the Euro and 10% vs the yen in 2003, the MSCI-EAFE Index—up 17.1% for the quarter and 38.6% for the year in US dollar terms—outperformed the S&P 500. Indicating the very significant effect

of currency translation in 2003, the respective returns on MSCI-EAFE were 9.3% and 20.3% in local currency terms. The improved worldwide economic prospects had a particularly dramatic effect in emerging markets, with the MSCI-EMF index registering impressive returns of 17.8% for the quarter and 55.8% for the year.

The fixed income market (*See Charts Six, Seven, and Eight*) registered positive returns but failed to beat the equity market for the first time in four years. Although

Treasury bond rates rose for the first time since 1999, their total return was still modestly positive. The yield on the benchmark 10-year note began the year at 3.82%, reached a 45-year low of 3.1% in early June as talk of deflation remained strong, but rose as high as 4.60% before settling at 4.25% at year-end as both the economy and the stock market dramatically improved over the remainder of the year. While returns on mortgage-backed securities were also only modestly positive, investment

Chart 2 | S&P 500: A Five Year Perspective

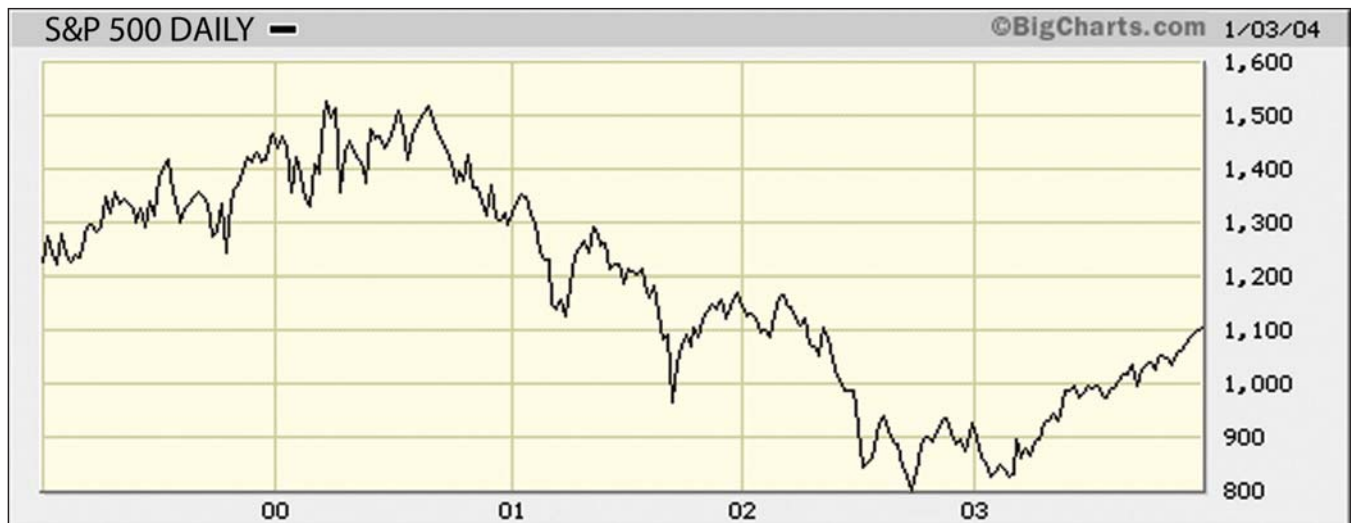


Chart 3 | S&P 500 vs NASDAQ: After Five Years, Almost Even



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grade corporate bonds enjoyed better performance as quality spreads narrowed in sympathy with the improving economy. The Lehman Brothers Aggregate index of investment grade securities was up 4.1% for the year. In its best year since 1991, the high-yield (“junk”) sector was clearly the place to be as returns for the year approached 30%.

With short-term rates remaining unusually low as a result of Fed policy while the longer maturities reflected traders’ prospects for

inflation down the road, the yield curve remained very steep. Ten-year and thirty-year US Treasury bonds offered yield advantages of 240 basis points and 325 basis points, respectively, versus the two-year note.

Despite the improving economy, the Fed stated that it was likely to maintain short-term rates at their current historic lows for the foreseeable future. Their position is buttressed by the core inflation rate of 1.1%, which is the lowest in almost 40 years, and the job

market, which remains weak. Nevertheless, many observers feel that it is only a matter of time before the central bank nudges the federal funds rate up from its current 1% level.

Real estate delivered another year of positive performance. In terms of fundamentals, very low interest rates allowed residential real estate to remain surprisingly strong in terms of home purchases, a fact which, along with the weak labor market, likely contributed to the apartment sector remaining

Chart 4 | S&P 500 vs Russell 2000: Small Caps Rule

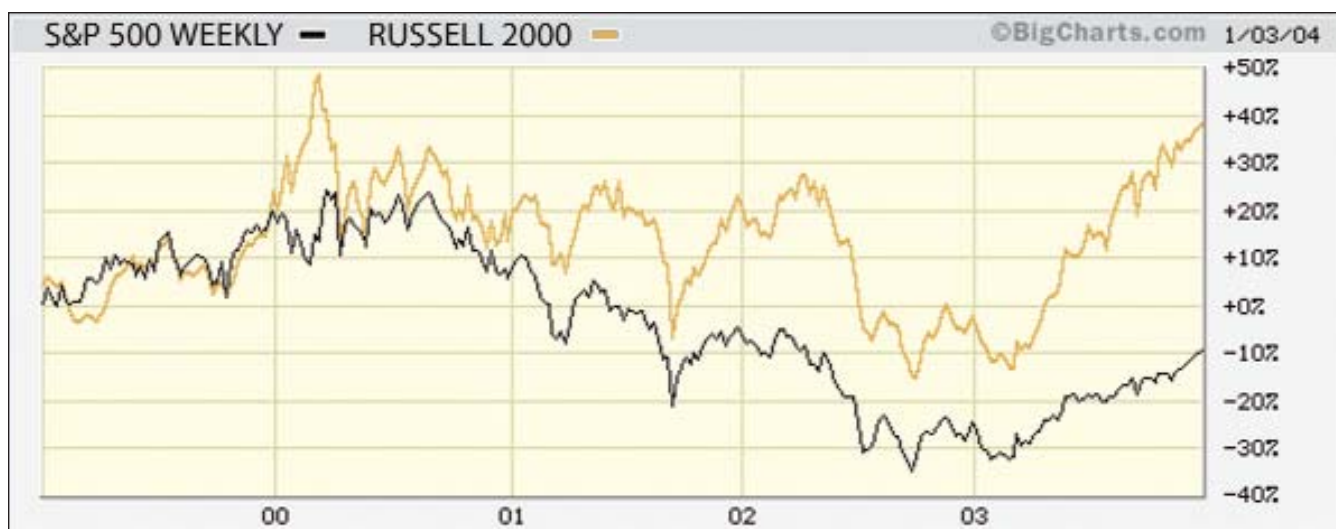
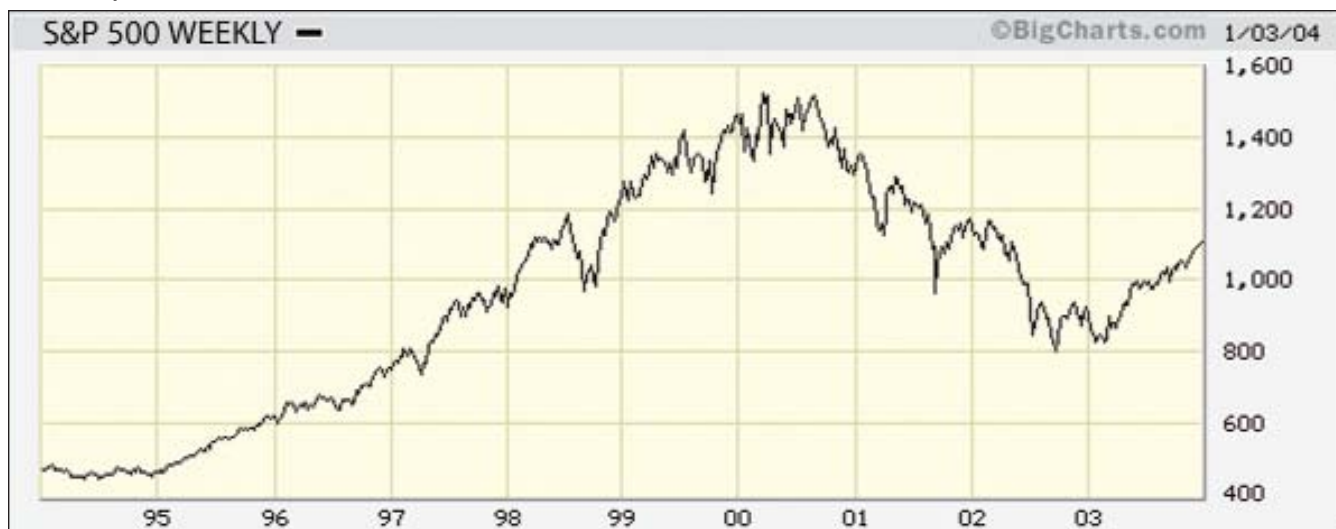


Chart 5 | S&P 500: A Ten Year Perspective



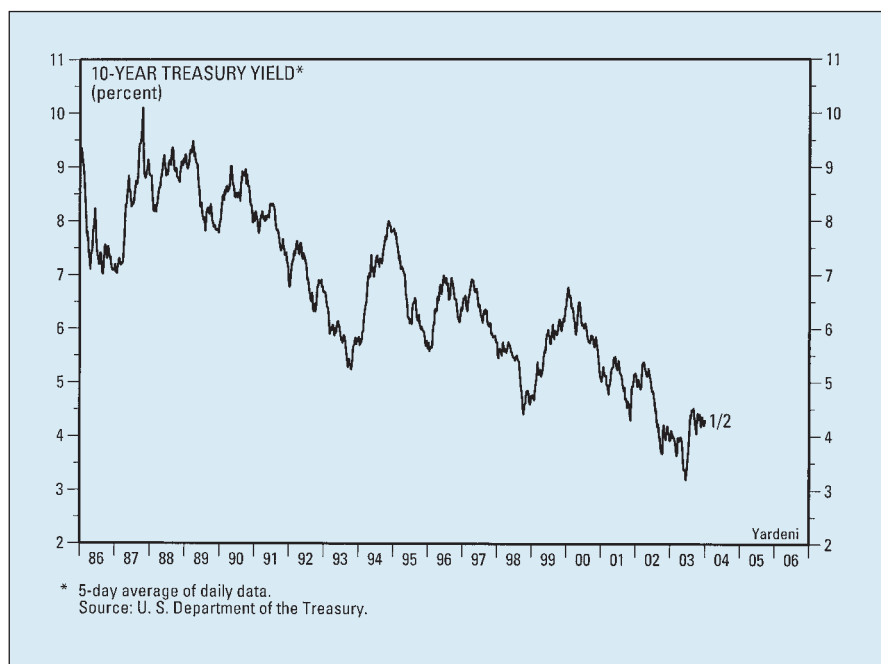
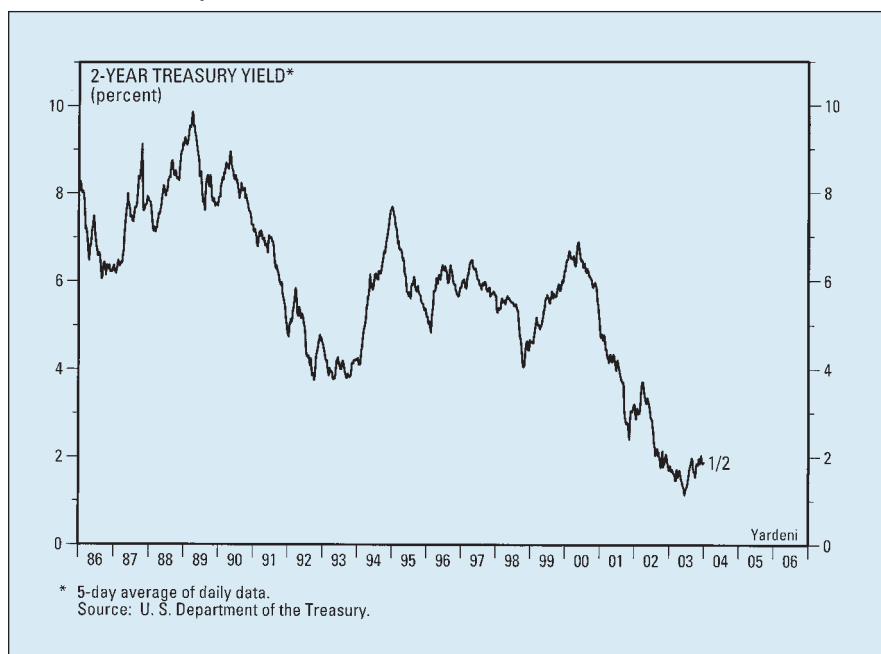
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somewhat weak. Continuing corporate cutbacks kept the commercial sector weak, with a vacancy rate at a 10-year high. Reflecting the frothiness of the stock market as well as the sector's attractive income component, publicly traded equity REITs returned about 10% for the quarter and 37% for the year. It was the fourth straight year that REITs have outperformed the S&P 500. Returns on privately-held real estate were more down-to-earth, with annualized returns in the range of 9%. Among sectors, retail was the best performer while office space was the worst.

Composite returns will not be available for several months, but with the market for initial public offerings beginning to show signs of life, spirits were improving in the beleaguered venture capital industry. The industry was still digging out from the rubble of the late 1990s bubble, but after many firms cut the size of recent funds and returned money to limited partners over the past year, new fundraising was re-starting and new investment was stabilizing at pre-bubble levels. Most new investment was going into later stage companies but there was renewed faith in start-ups. As one sign of improving market conditions, the median valuation of newly funded companies rose to the highest level since 2001.

Hedge funds are not a true asset class but a collection of different strategies aimed at delivering absolute returns. There is no all-inclusive index or universe of hedge funds, but the most widely followed indices are expected to report composite returns (over a wide range of different strategies)

Charts 6 and 7 | Interest Rates: Historically Low



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With the market for initial public offerings beginning to show signs of life, spirits were improving in the beleaguered venture capital industry.

in the range of 15-20% for the year, confirming the expectation that hedge funds protect principal during bear markets but will lag the major equity benchmarks during bull markets. After lengthy research and public hearings, the staff of the SEC presented an even-handed report on hedge funds, calling for mandatory registration but also recognizing the value of their absolute return objectives. A few hedge funds were implicated in improper trading activities involving mutual funds and a small number were charged with false pricing practices, but the industry avoided any major blow-ups and was still experiencing healthy growth in assets.

Both the economy and the stock market began 2004 with positive momentum, but there are questions that cloud the future. Economic growth could be derailed by possible occurrences such as rising interest rates, a spike in oil prices, a further major decline in the dollar, possible trade tensions, more disclosures of mad cow disease, and, of course, renewed terrorism. As for the market, many see it as "priced for perfection" with price/earnings ratios well above historical averages. At the least, strong continued earnings growth will be necessary for the markets to continue their 2003 advance.

In 2003, investors shrugged off the mutual fund scandals and other possible distractions to renew their investments in US equities in a major way. Public pension funds were relieved to exceed their targeted rates of return for the first time this decade and they hoped that the political and economic scenarios for 2004 would allow this to be more than a one-time occurrence.

Chart 8 | The Yield Curve: Historically Steep

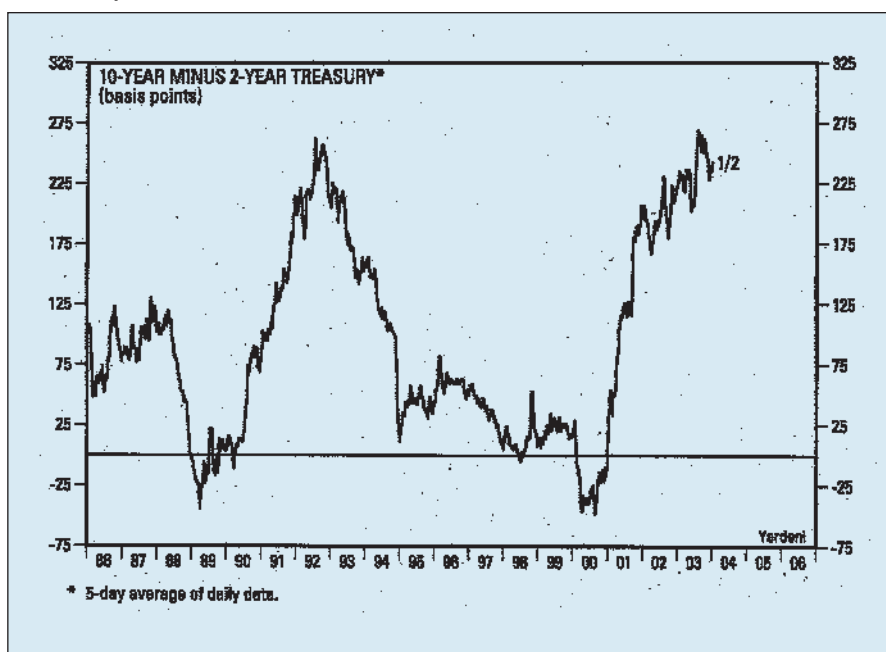
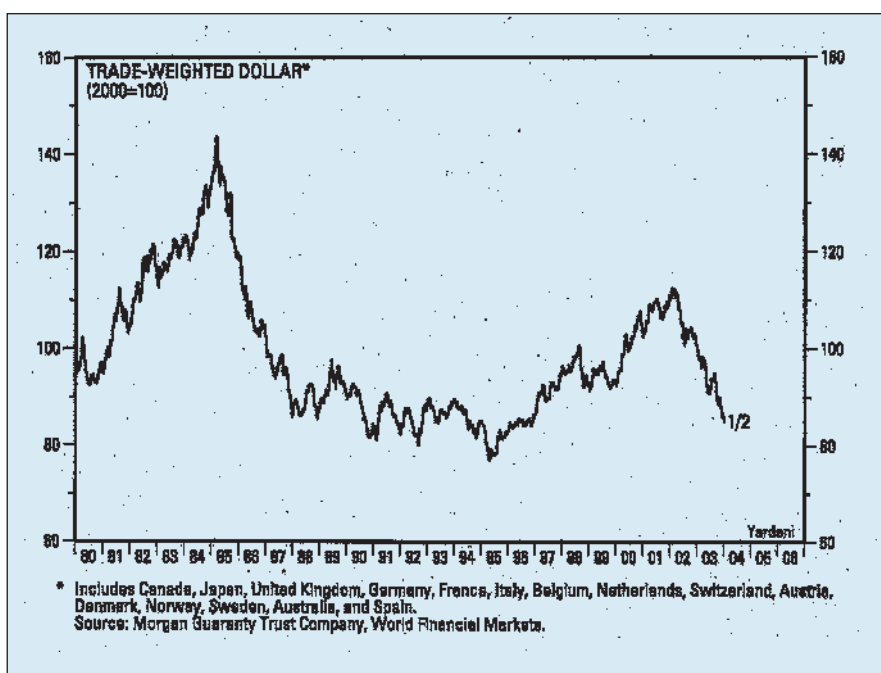


Chart 9 | Currency Market: Rise and Fall of the Dollar



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As always, the PERAC Investment Unit welcomes the opportunity to work with retirement boards and to provide assistance in any phase of their investment program.

TOTAL RETURNS | *4th Quarter, 2003*

INDEX	FOURTH QUARTER, 2003	FULL YEAR 2003
US EQUITY MARKET		
Dow Jones Industrial Avg.	+ 13.40%	+ 28.28%
Standard & Poor's 500 (Large Cap)	+ 12.18%	+ 28.68%
NASDAQ Composite	+ 12.10%	+ 50.01%
Wilshire 5000 (Broad Market)	+ 12.42%	+ 31.64%
Standard & Poor's Mid-Cap 400	+ 13.19%	+ 35.62%
Russell 2000 (Small Cap.)	+ 14.52%	+ 47.25%
GROWTH VS. VALUE		
S&P 500 Growth	+ 9.93%	+ 25.66%
S&P 500 Value	+ 14.46%	+ 31.79%
S&P Midcap 400 Growth	+ 9.81%	+ 30.95%
S&P Midcap 400 Value	+ 16.50%	+ 40.18%
Russell 2000 Growth	+ 12.68%	+ 48.54%
Russell 2000 Value	+ 16.37%	+ 46.03%
INTERNATIONAL EQUITY		
M.S.C.I. - E.A.F.E.	+ 17.08%	+ 38.58%
M.S.C.I. - Emerging Markets	+ 17.78%	+ 55.82%
FIXED INCOME		
Lehman Brothers Aggregate Index	+ 0.32%	+ 4.10%
First Boston High Yield Index	+ 5.83%	+ 27.93%
REAL ESTATE		
NAREIT - Equity Real Estate Investment Trusts	+ 9.96%	+ 37.13%
NCREIF Property Index	+ 2.03% (Q3)	+ 8.87% (Trailing)